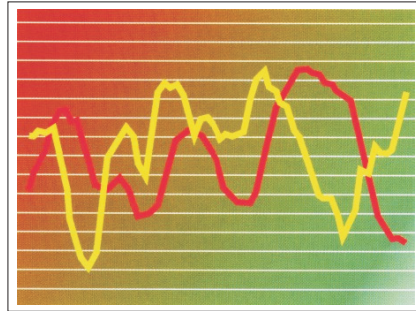


# CONJONCTURE IN FRANCE



## France: between convergence and financial uncertainties

**B**efore this summer's financial turmoil, the world economy was still growing at a brisk clip, despite a deceleration in some parts of the world. The financial turbulence may accentuate the current slowdown, but to a degree that is very hard to assess today. Banks are facing strong microeconomic uncertainty about borrower quality. These doubts affect the macroeconomic landscape: they generate a lack of visibility on banks' future credit-distribution behavior, on the functioning of markets that are now short of lenders, and hence on the ability of consumers and businesses to finance their projects.

However, assuming the financial difficulties are gradually resolved—thanks, in particular, to central-bank actions—the effects should remain moderate between now and end-2007.

The basic trends at work before the onset of the crisis should thus prevail in H2. In the United States, a further drop in residential-construction activity is expected, with household consumption restrained by lower real-estate prices and tighter lending conditions. As a result, U.S. growth will likely be modest. The euro zone, although still buoyant, is likely to lose some of its overall momentum, as foreshadowed by the decline in business optimism recorded in confidence surveys in the past few months. By contrast, we expect growth to persist in Asia (excluding

Japan), driven by an investment boom that has not flagged in over a year.

Despite this weaker environment, French growth should not dip in H2. On the contrary, short-term indicators point to a strong gain of 0.7% in Q3, followed by a more moderate 0.5% in Q4. This would put annual GDP growth at 1.8% in 2007.

The forecast H2 upswing is partly due to a "technical rebound." France's Q2 performance was undercut by one-time factors, and their disappearance is logically driving the growth rate upward in Q3. But the rebound also reflects a degree of convergence toward the rest of the euro zone. This pattern, reflected in business and consumer surveys, is at least partly due to the improvement in some sectors such as the automotive industry, which have been obliged to adapt their production facilities in recent years.

The French economy is projected to create nearly 340,000 new jobs in full-year 2007, in line with an excellent H1.

The main uncertainty in this scenario is the financial crisis. Its persistence would compromise the financing of many projects and dampen growth. Conversely, if financial conditions return to normal reasonably quickly and the promises of the confidence surveys are fulfilled, France could grow faster than in our scenario.

The world economy has been slowing since early 2007. In the industrialized countries, growth eased from 2.8% in 2006 to an annual pace of 2% in H1 of this year. In Q2, GDP growth greatly exceeded forecasts in the U.S. at 1.0%—notably thanks to inventories and trade—while was disappointing in the euro zone (which posted a gain of only 0.3%) and Japan (with a 0.3% contraction).

## Liquidity down sharply on many markets since August

Since mid-August, the growing difficulties in the U.S. subprime sector—the riskiest segment of the mortgage-loan market—triggered a financial crisis. Because of the increasing complexity of financial instruments and the spread of the risk to many players, the rise in defaults in this narrow segment of the credit industry eventually generated a near-universal loss of confidence across financial markets. Liquidity shrank in the money markets, driving their rates upward, while a widespread flight to quality moved yields on government securities downward (Chart 1).

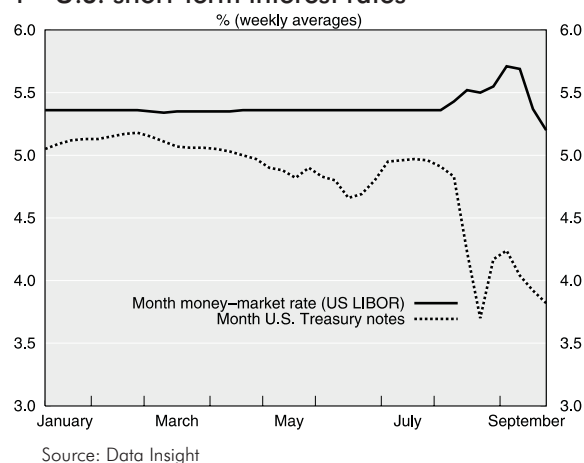
To tackle this crisis, the central banks began by injecting liquidity, then loosened their monetary policy. The U.S. Federal Reserve trimmed its discount rate on August 17; it then cut the Fed funds rate by 50 basis points to 4.75% on September 18.<sup>1</sup> The European Central Bank cancelled the rate hike initially planned for September 6, announcing that it would wait for more information before charting future policy.

The microeconomic repercussions of the financial turbulence are very hard to assess. Banks face exceptional uncertainty over borrower quality. As long as doubts persist, one cannot gauge the ultimate potential effect of the crisis on banks' lending behavior and interest rates. Central-bank actions—particularly the Fed's latest cut—should, however, restore confidence in financial markets, raising hopes that the crisis will have only a moderate impact by end-2007.

In H2, world growth is likely to ease independently of the crisis, despite the emerging economies' robust performance. The overall outlook in manufacturing and services in the OECD countries weakened in July-August, returning to early-2007 levels.

Moreover, oil prices continued to rise in early Q3. On 20 July, Brent crude hit a record at nearly \$80/barrel.

### 1 - U.S. short-term interest rates



1. At the same Open Market Committee meeting, the Fed also cut its discount rate by a further 50 bps.

After retreating in early August, prices started climbing again. On a supply-constrained market sensitive to geopolitical factors, prices should remain volatile in the months ahead. Our forecast assumes an average Brent price of \$75/barrel to year-end. Oil-market tensions are compounded by faster growth in agricultural and commodity prices. The uptrend is set to continue in H2, causing an increase in inflation at end-2007 that is likely to curb real household income.

## U.S. economy expected to slow in H2

The U.S. growth outlook has darkened, owing to further delay in the expected stabilization of the real-estate market. Unsold housing inventories remain high, developers' confidence is slipping again, and real-estate prices are still falling. Moreover, the weakness of net job creation in the U.S. will likely persist, with virtually unavoidable losses in the residential construction sector. Both developments should restrain personal consumption expenditures (projected to gain 0.3% in Q3 and Q4), and residential investment (forecast to slip 2.6% per quarter in H2). Annual average GDP growth is thus set to weaken from 2.9% in 2006 to 1.8% in 2007.

Although particularly hit by the financial crisis, the British economy is expected to post vigorous annual growth of around 3.0%. The latest industry surveys show productive investment on a strong upward path in H2. In addition, the easing of inflation since early 2007 should provide households with real income gains, keeping their consumption robust.

Japan's economy is set to expand again in the coming months after a decline in Q2 due to a sharp fallback in domestic demand. But expansion will likely be limited by anemic household demand. Annual average GDP growth is forecast at 1.9%, down from 2.2% in 2006. Deflationary pressures persist, and the yen's appreciation could undermine the trade performance.

The emerging countries—most notably China, India, and Russia—should stay on a high-growth track. China shows no tangible sign of slowdown. Year-on-year GDP growth topped 11% in Q2, as in the previous quarter. The economy is expected to remain vibrant. The monetary authorities' efforts to dampen it have apparently been fruitless so far. The South-East Asian countries should continue to benefit from the Chinese growth momentum, and the acceleration of productive investment seems to indicate that the investment cycle will continue.

## Euro-zone growth still fueled by domestic demand

The euro-zone economy is forecast to grow by an annual average 2.6%, nearly matching its brisk 2006 pace of 2.9%. Despite anemic residential investment, domestic demand should provide momentum in H2. By contrast, external trade is expected to suffer from the weaker international environment. Assuming an average exchange rate of \$1.40 per euro to year-end, the trade contribution to euro-zone growth should thus be slightly negative within the forecasting horizon.

Germany should continue to benefit from its health trade performance in 2007. Annual average GDP growth is

forecast at 2.6%, of which external trade will likely contribute 1.2 points. However, as in the euro zone as a whole, the trade contribution is expected to be slightly negative in H2. During that period, the German economy is projected to grow at an annual average pace of about 2%, significantly below the 2006 figure. Our scenario nevertheless calls for a one-time acceleration from 0.5% in Q3 to 0.6% in Q4, as German firms will probably anticipate their investment expenditures in late 2007 in order to take advantage of final opportunities for extended tax write-offs before these expire on January 1, 2008. Moreover, after several years of wage restraint, 2007 could see a recovery in wage growth. The increase in wages and salaries is forecast to quicken to an annual average 1.6% in 2007, the steepest gain in six years. Given the brisk pace of job creation, German households should enjoy a real-income rebound in H2. This is expected to boost personal consumption growth to 0.7% in Q3 and Q4. For 2007 as a whole, however, these developments are unlikely to offset the negative impact of the VAT shock in Q1 on household spending. We therefore predict a stagnation of average annual growth in private consumption, despite its acceleration on a quarterly basis.

In Italy, the new deterioration in industrial activity, attested by surveys since end-Q2, points to a further decline in industrial production in H2. The Italian economy will likely continue to be burdened by structural problems in productivity and competitiveness. As a result, and despite a substantial statistical overhang of 1.1 points at the start of the year, average growth for 2007 is forecast at a modest 1.8%.

### French exports driven by the euro zone and emerging countries

In this slacker international environment, world demand for French exports should grow at its long-term pace in 2007, with the euro zone and the emerging countries as the main drivers. French trade is actually expected to post strong gains in Q3, as suggested by July customs data and the increase in export order intake.

Nevertheless, the manufacturing trade balance is likely to undermine the total French trade balance on an annual-average basis. The euro's appreciation should cause a mild loss of price-competitiveness. Manufactured imports should also be spurred by vigorous consumer demand. In H2, however, the contribution of trade to GDP growth is projected to return to zero. Driven by brisk agrifood and energy exports—in the latter category, partly thanks to an unusual increase of refined-product exports in July—exports and imports of goods and services are forecast to grow by an annualized 5.1%.

### Robust industrial production and investment

Apart from the financial sector, we expect strong growth in the main industries in H2. After a disappointing Q2, manufacturing production should display renewed vigor in H2 (Chart 2). All of the short-term information on Q3—particularly the confidence surveys in industry—points to an improvement in manufacturing output during the summer. We expect the aggregate to gain 0.8% in Q3 after a 0.5% contraction in Q2. After a

difficult early 2007, the automotive sector should rebound thanks to the release of new models. However, production is likely to have declined in August, owing to a higher-than-usual concentration of employees' annual leave that month.

Production in services is also forecast to be robust in H2. Business surveys have been extremely upbeat in Q3, in particular for personal services. Our forecast puts total production of goods and services at 2.0% in 2007, with a mild slowdown by year-end.

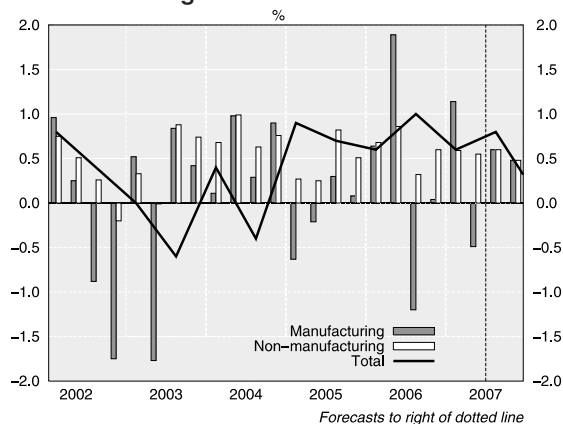
After a very good Q1, the Q2 correction in capital-goods investment came as a surprise. This temporary pause does not call into question the overall dynamics of productive investment. Admittedly, investment in buildings and civil engineering is expected to keep growing at a moderate pace in H2, most notably on account of the rainy summer. But investment in manufactured products is set to expand by an annualized 5% between now and the end of the year. This scenario rests on the likelihood that relatively vigorous demand will incite business owners to boost productive capacity. Meanwhile, tighter financing conditions are not expected to cause more than a mild dip in business investment at year-end. We therefore project business-investment growth to quicken from 4.6% in 2006 to 4.9% in 2007. Should the financial crisis persist, however, the uncertainty on future growth—and hence on market demand—could intensify. If so, firms may adjust investment downward in late 2007.

### Job creation running high in 2007

Amid favorable conditions, the labor market should continue improving in the months ahead, although without matching the exceptional total of 212,000 new jobs in H1. The non-farm market sector is set to add 100,000 jobs in H2. The most job-creating sectors in 2007 are expected to be personal services and business services, with increases of 84,000 and 103,000 respectively. Market services are poised to add 256,000 jobs in 2007, up from 187,000 in 2006. Despite a decline in subsidized jobs in H2, the total economy is forecast to create 340,000 jobs in 2007, compared with 285,000 in 2006.

Because of the slower growth in the labor force, the quicker pace of job creation should lead to a substantial decline in unemployment in 2007. Over the full year, ILO unemployment could decrease by about

### 2 - Production growth



Source: INSEE

200,000—a figure not immune to possible revisions in the measurement of unemployment resulting from a methodological review of the Labor-Force Survey now nearing completion.

### **Faster growth in households' real income should fuel their consumption**

The growth in real household disposable income is forecast to quicken sharply in H2, exceeding an annualized 4%. The main stimulus will probably come from the persistence of buoyant wage growth, fueled by the steady improvement in the labor market. The second expected driver will be faster-rising property income. Thirdly, households should benefit from several tax-relief measures, including the income-tax cut<sup>2</sup> and, in Q4, a reduction in social contributions due to the tax exemption on overtime pay.

The real-income acceleration should, however, be curtailed by the year-end upturn in inflation, mainly fueled by the steeper rise in food prices. Our scenario puts year-on-year consumer-price inflation at 1.9% in December. But, despite labor-cost pressure, we expect core inflation to remain stable.

This improvement in real income should lift personal consumption by 0.9% in Q3 and 0.7% in Q4. The increase should be particularly sharp for manufactured products between now and year-end. The available

figures for July-August point to 1.8% growth in Q3. Meanwhile, spending on services is likely to keep expanding at its present brisk pace.

On an annual average, however, household consumption growth is not expected to exceed 2.1%. The personal saving ratio should move up from 15.4% in 2006 to 16.3% in 2007, in step with quicker income growth. Given the more moderate rise in residential investment, the financial saving ratio is forecast to increase from an average 5.5% in 2006 to 6.5% in 2007.

### **A financial crisis with uncertain repercussions**

Overall, we expect French GDP growth to recover—partly because of a technical rebound effect—to 0.7% in Q3. The pace should ease to 0.5% in Q4, putting annual average growth for 2007 at 1.8%. This forecast is based on the assumption that the effects of the financial crisis will remain moderate in Q4. If the crisis persists, firms may defer some investment projects owing to a lack of visibility on future market demand or to difficulties in financing those projects—and economic growth would thus be reduced. Conversely, if financial conditions return to normal fairly soon and if the optimism measured in business surveys fully materializes, then French GDP could grow more vigorously than in our scenario. ■

2. The H2 income-tax cut goes beyond the reduction in the advance installments paid by taxpayers in February and May (*acomptes provisionnels*), a measure implemented in early 2007.